THE LAW OF CLEARING HOUSES.

NO SINGLE subject of law which is the predicate for daily transactions amounting throughout a given jurisdiction to millions of dollars is contained within as small a compass, so far as precedent is concerned, as that relating to clearing houses. It is safe to say that that compass is bounded by a round dozen of adjudged cases.

A clearing house association is a voluntary association, generally unincorporated, created by the coöperation of banks doing business in one locality to afford a uniform and convenient method of obtaining daily settlements of balances among them, and also, if desired, to issue clearing house certificates secured by pledge of collateral, available as cash in times of financial stringency and panic. Yardley *v.* Philler.[1] This object may be reduced to the few words used by the Supreme Court of Pennsylvania in Philler *v.* Patterson[2]—to facilitate exchanges.

To Albert Gallatin must be given large credit for originating the clearing house system. In 1831, he published a pamphlet of 124 pages, entitled "Suggestions on the Banks and Currency of the Several United States in Reference Principally to the Suspension of Specie Payments." Certain of these suggestions are pronounced by Mr. James G. Cannon, of New York, to contain "the very quintessence of the clearing house system." "But," adds Mr. Cannon, "the times were not ripe for the scheme thus proposed. Mr. Gallatin was thinking in advance of the age. More than twenty years passed by before his fellow bankers could appreciate the wisdom of his suggestions."

To appreciate the facilitation of business afforded by the new system, the student of the history of banking in this country has, therefore, only to look backward a little more than half a century. Take the single case of a commercial center of any size

[1] 167 U. S. 344, 42 L. Ed. 192.
[2] 168 Pa. St. 468, 32 Atl. 26, 47 Am. St. Rep. 896.

in which were, say, five banks, each receiving daily from its depositors checks upon the other four. Even in those early days, economy of time and clerical assistance required that these checks be retained until after the close of banking hours and then segregated and presented as one demand upon each of the drawee banks. But the presenting agent either passed on the way four several agents of the other banks with reciprocal demands upon his institution, or, when he presented his four several packages of checks, was met with a counter-demand, totalling either more or less, as the case might be. In the latter event, should the balance be in favor of Bank Number 1, it would be paid to the agent in cash, the mutual items surrendered and the transactions of the day closed. If, however, the balance was in favor of the drawee bank, one of two things was necessary—the sending of its messenger for the cash or the acceptance by it of an acknowledgment of indebtedness for the amount.

This congestion was in the due course of those leisurely days perceived to be intolerable and instead of an increasing multiplication of clerks and salaries, division and simplification were demanded. The response came in the shape of a system which was the genesis of the modern clearing house association, of which it is not too much to say that for simplicity, accuracy and time-saving in the handling of enormous money-equivalents, it has no superior—if it has an equal—in all the banking and commercial world.

Today, the five banks meet and agree that in order to dispense with the handling of money, each shall deposit in the hands of a committee either cash or securities at a fixed ratio of their capital stock or general deposits, for which the committee shall issue certificates to be used in paying daily balances against the several members. This deposit made and certain rules formulated for the conduct of the business, the association begins its active operations. Daily, at a designated hour in the morning, two representatives of each bank meet at a designated place, present and surrender their items on the others, receive the counter-demands, await for a few minutes the ascertainment by the clearing house official of the result and the issuance of the proper certificate of debit or credit, and then return to their several

banks. There, an examination is at once made of the checks received and if any are found subject to exception which would justify their rejection if presented for payment in cash at the teller's window—"no funds," "not sufficient funds," "not properly endorsed," "payment stopped," and the like—they are returned by a designated hour, usually 12:30 or 1:00 p. m., to the bank whose endorsement they bear, and are promptly redeemed.

The foregoing is, of course, only an outline of the system. A personal examination of the machinery of a clearing house—a careful study of the noiseless way in which the big wheels revolve—is recommended to both lawyer and layman.

It is doubtless because of the simplicity and perfectness of the system that so few controversies have arisen from it, the judicial decision of which must form the law of the subject. Another reason may be that for once the parties to the several agreements—which are substantially identical throughout the United States—have expressed themselves so clearly in their articles of association that there has been little for the courts to pass upon.

We will now consider, however, certain of the dozen reported cases upon the law of clearing houses.

VALIDITY.

In Philler *v.* Patterson,[3] an agreement among national banks of a city for the formation of a clearing house association, where the purpose was to facilitate the legitimate business of the banks, no element of speculation and no business undertaking by or on behalf of the associated banks being contemplated, was held to be not a violation of the laws relating to national banks.

RELATIONS.

In Rector *v.* City Deposit Bank Co.[4] and Rector *v.* Commercial National Bank[5] it was held that clearing house associations are agents for the banks composing them, that is, their duty to clear or balance daily the claims of the respective banks, one against the other, resulting from the checks drawn upon and

[3] *Supra.*

[4] 200 U. S. 405, 50 L. Ed. 527.

[5] 200 U. S. 420, 50 L. Ed. 533.

held by the different members. The only source from which the association derived the means to carry on its operations was from assessments upon the members, which were made solely for the purpose of paying rents, salaries, and similar expenditures. To effect the clearings each member of the association, on banking days, sent to the clearing house, at a specified hour, the checks held by it against the other banks. The checks sent by each member were considered as remaining the property of the member, the association being simply an agent for collection. Where a bank was entitled to a credit or payment corresponding to the excess which the sum of the checks presented by it exceeded the sum of the checks against it, the clearing house paid that bank the difference by drawing its check upon one or more of the debtor banks; and each member constituted the manager of the association its agents to draw a check or checks upon such member for any balance found to be due by that member.

In Crane *v.* Fourth Street National Bank [6] it was held that a clearing house association, though occasionally issuing certificates which pass as currency, is not a mutual bank, organized and operated by the associated banks.

PAYMENT.

In Crocker-Woolworth National Bank *v.* Nevada Bank [7] payment through a clearing house was held to amount merely to a system of set-offs and cancellations, whereby accounts are settled between members without the actual transfer of unnecessary funds. In Dedham National Bank *v.* Everett National Bank [8] it was held that where forged checks, payable to cash, were deposited with defendant bank, and paid to it through the clearing house by plaintiff bank, the drawee, the fact that defendant had not required endorsement of the checks would not render it liable to refund the money received, on the ground that such fact led the plaintiff to believe that the checks had been cashed for their apparent maker, since there was no custom for such requirement nor any duty of defendant to anticipate such result.

[6] 173 Pa. St. 566, 34 Atl. 296.
[7] 139 Cal. 564, 73 Pac. 456, 96 Am. St. Rep. 169, 63 L. R. A. 245.
[8] 177 Mass. 392, 69 N. E. 62, 83 Am. St. Rep. 286.

This does not mean, of course, that forged or worthless checks can not be returned to the member bank from which they are received, if the return is made by the hour prescribed by the rules. Nor is a return at or before the prescribed hour indispensable, if the bank to which the rejected item is tendered has not suffered loss or has not changed its position by reason of the delay.[9]

Rules and Customs.

These, if reasonable, are valid. It is competent for member banks to make rules governing, as between them, the effect of endorsements of negotiable paper, and such rules supplement the law on the subject.[10] But the rules are adopted solely for purposes and benefit of the member banks and do not affect the rights and liabilities of banks and persons who are not members of the association or parties to its regulations.[11]

Insolvency of Member Bank.

In its capacity for meeting this emergency lies the real merit of the system. Should it prove valueless as against unforeseen insolvency—should the settlement of transactions for only one day be left to the supposed ability of the drawee bank to meet its obligations—the perfectness of the system would be seriously marred. As has been seen, however, a measure of insurance against insolvency is secured by the requirement of a deposit of collateral in an amount proportioned to its general deposits.[12]

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[9] Atlas National Bank *v.* National Exchange Bank, 176 Mass. 300, 57 N. E. 605; Merchants National Bank *v.* National Bank, 139 Mass. 513, 2 N. E. 89, disapproving Preston *v.* Canadian Bank, 23 Fed. 179.

[10] Crocker-Woolworth National Bank *v.* Nevada Bank, *supra.*

[11] Manufacturers National Bank *v.* Thompson, 129 Mass. 438, 37 Am. Rep. 376; National Exchange Bank *v.* Ginn, 114 Md. 181, 78 Atl. 1026.

[12] The following summary of the law in point is taken from Michie, Banks and Banking, 2287:

"Failure of a bank, before settlement for the day with the clearing house association, but after surrendering demands against other banks and receiving credit on the settlement sheet, does not deprive the association of the right to collect such demands, and apply the proceeds to settle debits against the bank in accordance with the rules. Yardley

Liability of Member Banks for Banks for Which They Clear.

A review of the subject would not be complete without at least a reference to the liability of a member bank for checks upon banks which are not members but for which it clears. This is generally covered by an article to the effect that the liability shall be the same as for its own transactions and shall continue until notice in writing of the discontinuance of such agency shall have been delivered to the other members of the clearing house, but this notice shall not be operative as against local outdoors collecting departments of the members until it shall actually have reached the clerks engaged in making collections and in such case in no event later than a named hour, e. g., 4:00 p. m., of the day upon which notice is given. Banks clearing for non-members protect themselves in the same manner as they are protected against defaults by members, that is, by requiring the deposit and assignment of securities in an amount proportioned to the deposits of the non-member banks. A further protection is the daily balance which the non-member carries on the books of the clearing bank.

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v. Philler, 167 U. S. 344, 42 L. Ed. 192. But the clearing association has no lien giving it the right to appropriate, to an indebtedness due it on loan certificate account, against the receiver representing the other creditors, the balance appearing in favor of an insolvent bank, upon the last daily clearing made of the day of its failure, arising in reality after the insolvency from the withdrawal, by the banks presenting them, of the checks held against the insolvent bank. Yardley *v.* Philler, *supra*. The appropriation of such balance by the association is a preference within the inhibition of a statute (Rev. Stat., § 5242) against preferences in the cases of insolvent banks. Yardley *v.* Philler, *supra*. A bank which, in payment of a result of the day's clearings, receives the proceeds of checks presented by such other member for clearing on the next morning, shortly before suspending payment, must account therefor to the bankrupt estate of such defaulting member, where the clearing house, in the revision of the clearings made necessary by such suspension, eliminated and returned the checks which had been debited against the defaulting member, and which were subsequently dishonored. Rector *v.* City Deposit Bank Co., 200 U. S. 405, 50 L. Ed. 527."

RIGHT OF CUSTOMERS OF MEMBERS TO CLAIM THE BENEFIT OF THE RULES AND USAGES OF A CLEARING HOUSE.

This is an interesting phase of the subject and reference to it has already been made in this article. It occasioned at first some difference of judicial opinion, which has been resolved in recent years into a substantial uniformity of view against the right of privity or subrogation in any form.[13]

In Manufacturers National Bank *v.* Thompson,[14] the bank having discounted a note sent it through the clearing house for payment, charged it to the bank at which it was payable. The teller of the bank, erroneously supposing the maker was in funds, stamped it "paid." The mistake being discovered, the other bank and the endorser were notified of it before the close of banking hours, and the note was duly protested. The paying bank afterwards paid it to the discounting bank and sued the endorser.

There was a dispute between the banks as to whether, under the rules of the clearing house, the paying bank was not bound to return the note if not paid, by a given hour of the day on which it was due, and it was contended that, as the note was not so returned, it had become the property of the paying bank.

The court said:

> "There is no pretence that the note has ever been paid by the makers or endorsers, and there is nothing in the rules of the clearing house association which the defendants as endorsers of the note can set up by way of forfeiture or estoppel to defeat the right of the holder to recover against them. The rules of the association are adopted solely for the purpose of facilitating exchanges among the banks. The defendants (endorsers) are not members or parties to its regulations, and whatever effect is to be given them as between the banks, the defendants are not in a situation to claim the benefit of them. Overman *v.* Bank, 1 Vroom

[13] 5 Cyc. 614: "Banks may make rules for securing the payment of balances that may be found due from one member to another; but the rules and usages of a clearing house are for the benefit of its members and their customers can neither claim the benefit of nor be injured by them."

[14] *Supra.*

(N. J.) 61. There was no evidence that the defendants, as endorsers of the note, suffered any loss or changed their situation in respect to the makers of the note, by the mistake of the plaintiff. The note was regularly protested and notice to endorsers given. Their rights were in no way prejudiced. The finding of the court that the note is still an outstanding unpaid note was therefore clearly right."

In the New Jersey case above mentioned, the court said:

"The plaintiff avers that he was the holder of the check at the time of presentation and that he presented it to the Ocean Bank, who at the time was the agent of the defendant to receive demand of payment. Under this state of facts, the plaintiff shows no interest in the contract on which he counts. He shows himself to be a stranger to it in every sense. The Ocean Bank is not his agent, but that of the defendant; he can claim no benefit of a contract between the defendant and its agent.

"Neither the plaintiff nor the defendant were members of the clearing house association, nor does the declaration state that the plaintiff, when he left the check with the Bank of Commerce, knew of the existence of the usage, or in any way modified his contract with that bank for the collection of the check so as to embrace the benefit of that usage for himself.

"If the Bank of Commerce, in pursuance of that usage, had a right to hold the Ocean Bank for a failure to comply with its terms, could not that bank relieve the Ocean Bank of such liability without incurring any to the plaintiff? It could do so, for the manifest reason that this usage, in contravention of the common law, formed no part of the contract between the plaintiff and the Bank of Commerce. It could not, unless adopted and sanctioned by both parties, be binding on both."

The same view of the law was taken by a New York court in 1908 in the case of Citizens Central National Bank *v.* New Amsterdam National Bank.[15] It was held that the rule fixes the time at which a member bank may assume that a check presented by it is good in order that it may pay out the proceeds to a depositor and does not restrict a bank, discerning that a check is not good, to the time limit fixed for returning it, where the

[15] 109 N. Y. Supp. 872.

situation of the parties has not so changed as to cause loss to the bank to which the check is returned.

Said the court:

"The payment through the clearing house can not be treated as voluntary, with full knowledge of all the facts. O'Brien *v.* Gunst, 146 N. Y. 163, 28 L. R. A. 361; Mt. Morris Bank *v.* Twenty-Third Ward Bank, 172 N. Y. 244.

"The check was not extinguished by the payment nor was the endorser thereon discharged. It was within the power of the defendant bank to protect itself after 1 o'clock of that day by protesting the check. The plaintiff bank stood helpless in that regard. If the defendant had repaid the amount of the check at 10 or 12 minutes past 3 o'clock, it would have been in no worse position toward the maker and endorser than it was at 3 o'clock. There is no evidence of any change of position of the defendant. * * * The maker of the check was not released. Crawford's Annotated Negotiable Instruments Law, § 322. Brush *v.* Barrett, 82 N. Y. 400. The presentment of the check after business hours was sufficient to hold the endorser."

The great weight of authority is to the foregoing effect. In 1883 a federal court in Illinois criticized the ruling of the Massachusetts Supreme Court above mentioned and held that one o'clock means one o'clock and not later, whatever may have been the relations of the parties. A text-writer has recently said, in commenting with approval upon the Massachusetts decisions:

"In the absence of a very explicit provision to the contrary, the rule should be held only to fix an hour at which the banks sending the checks to the clearing house are warranted in treating them as paid in their dealings with their depositors or others. This seems a sufficient object and accomplishment for the rule. The strict construction contended for in the federal case cited tends too much to the infliction of a penalty, a result not favored by the law."

There is no reported case in Virginia in point, but in the year 1913, Hon. Beverly T. Crump, judge of the Law and Equity Court of Richmond, in the case of First National Bank of Richmond *v.* National State and City Bank of Richmond, ruled in

accordance with the views of the Supreme Court of Massachusetts in Manufacturers National Bank *v.* Thompson.[16]

The signs of the times point to the increasing importance of the clearing house in the financial life of the nation. It has already done great service in times of money stringency, its certificates being accepted as cash, although it should be noted as a part of the history of commerce and banking in Virginia that in the tight times following 1907, the city of Richmond was one of a very few in the country where resort was not had to clearing house certificates. One of the developments of the Federal Reserve Law may be clearing houses which shall include States and even federal reserve districts instead of single localities. If so, there will be a change only in the size and in the number of parts of the big machine, the harmonious action of which will continue to be a model for all who seek to lengthen life by eliminating unnecessary labor—a model, also, for those who would bring the commercial elements of a community of whatever size into the close touch and united action which must surely result both in the conservation of its values and in the multiplying of their effective uses.

George Bryan.

RICHMOND, VIRGINIA.

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[16] *Supra.*